Time to Fold the Fed

By

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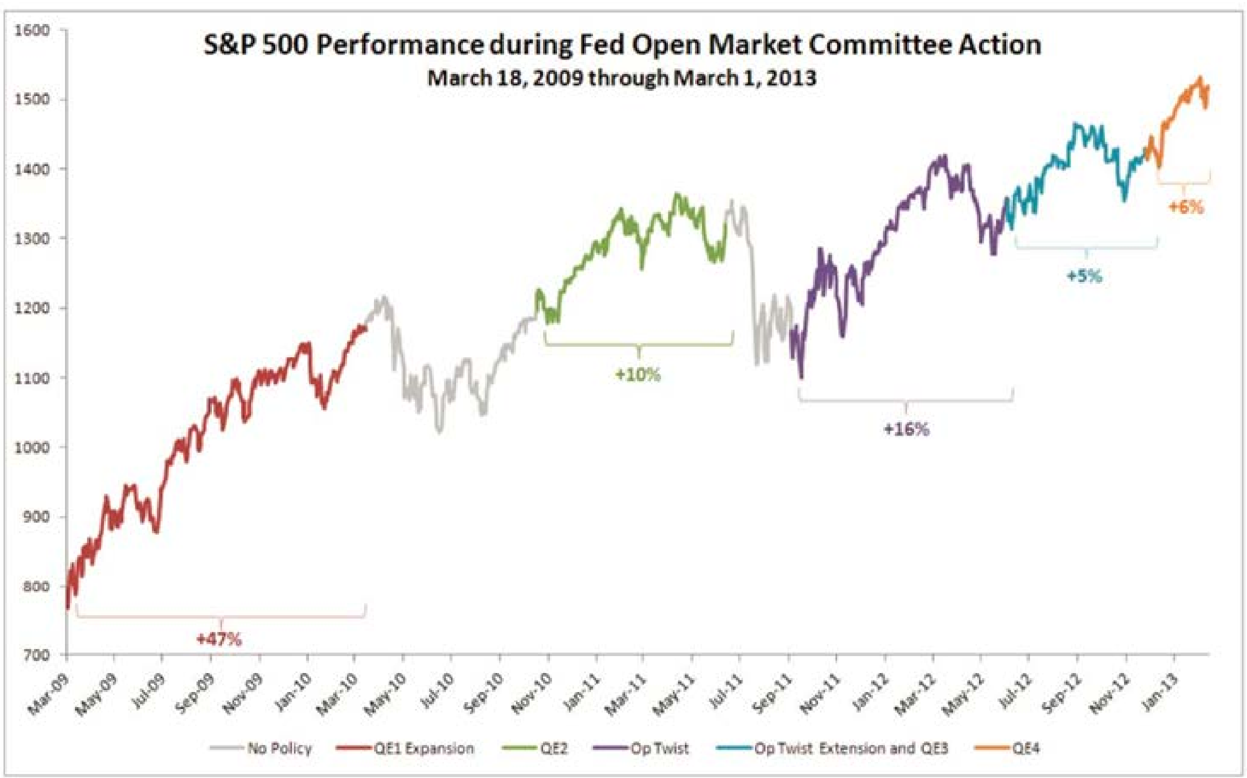
The effects of the Federal Reserve's on-going policy of artificial money creation are well documented by now. For a quick recap and as the saying goes: A picture is worth a thousand words. We clipped this chart below from the web, and which is self-explanatory; it clearly shows the strong correlation between periods of official money creation and periods of increase in the level of the S&P500.

Given that price levels reflect a relative abundance or scarcity of a certain supply against a certain demand, an increase in the supply of money against a fixed amount of shares in the equity indexes naturally increases the price of the index, and with all other variables remaining equal.

Clearly, the bulk of the upwards variation is a direct result of the debasement of money, and even more so that the economic picture has not improved to most, except for the direct beneficiaries of the scheme, such as the Fed's large banks, the government, and corporations with significant debt balances.



QE = Quantitative Easing programs.
Source: Bloomberg, DoubleLine Capital

Noteworthy on the chart is how the index would precipitously fall and erase many months of supposed appreciation towards the expiration of each of these rounds of artificial money additions.

While the idea that a central bank would go to counterfeit the same money it is chartered to preserve seemed like outright insanity back in 2009, and when a first such experiment was decided, it has become a fool's paradise by now, and going well into its 5th year since the implosion of the centralized banking system.

The S&P is hence totally dependent on such a form of life-support; it cannot stand up on its own and is totally disconnected from the economic reality it is meant to represent.

A more or less similar situation is clearly obvious in the bond market, and consequently, all the financial markets are unable to discover their true value and remain hostage to the Fed.

Given the severity of the financial collapse which took place under the watch of the central bank, and the enormity of hardship inflicted on the American public, and major regions in the world, it truly is shocking that no admission of guilt was ever expressed, no responsibility was taken, and less than a handful of resignations took place.

Adding to an inexistent accountability, the Fed proceeded to sell a 'rescue plan' with names ranging from 'quantitative', to 'easing', to 'twisting', to 'extensions', still hoping to grant itself some credibility.

A lesser known phenomena than the undeniable effect of artificial purchases of financial assets, is the very significant effect the Fed has always had in fact on the markets, be it so obvious as post 2008, or less so.

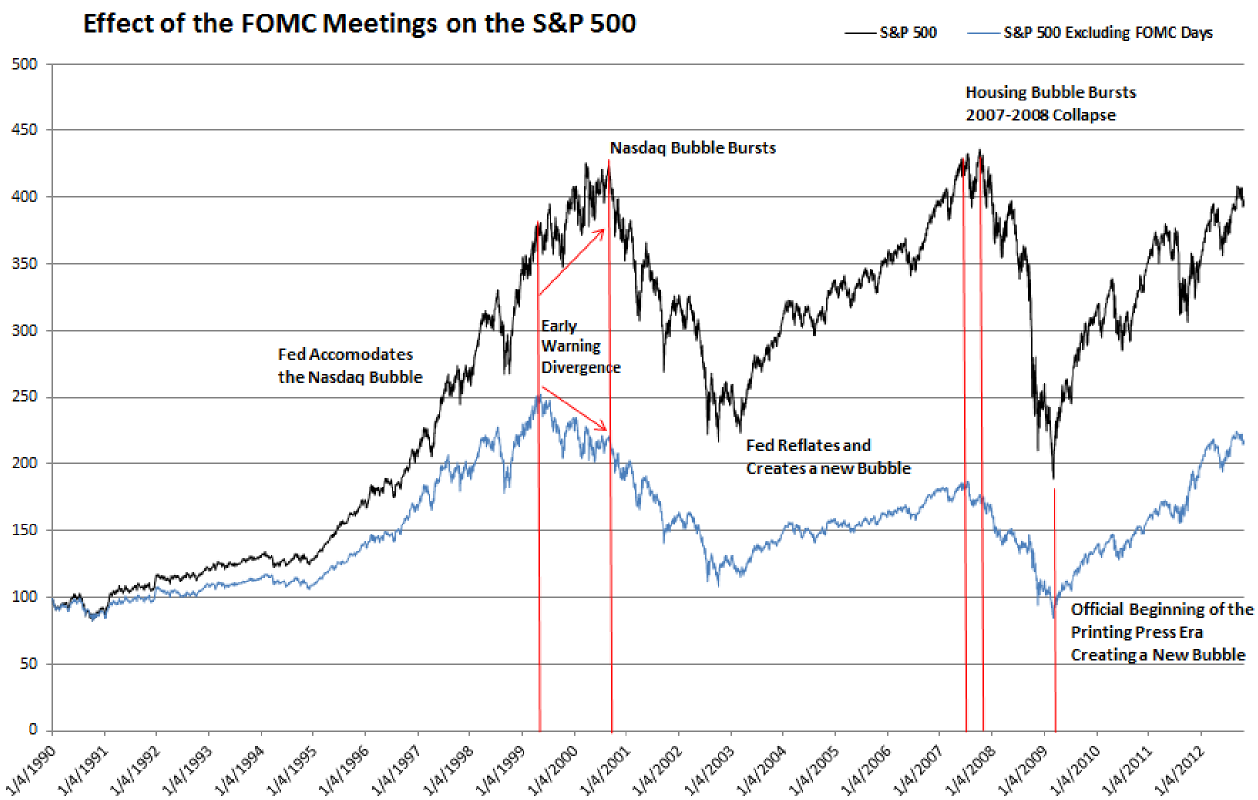
The chart below shows the cumulative return of the S&P 500 against its adjusted returns excluding the FOMC meetings; in specific, returns on the meeting day and including 1 day before and 1 day after have been removed from the series and have not been accounted for. This simple and efficient analysis makes minimal assumptions and focuses on the price changes in the S&P excluding the meeting dates.[1]

Given the major divergence between both series, the impact of the FOMC meetings couldn't be anymore obvious; the chart shows that discounting the FOMC meetings by excluding the index's data surrounding the meetings produced a totally different index than would have been the case otherwise.

The FOMC meetings boosted the S&P returns to extremes, and well beyond any balanced monetary policy. The only exception were for periods following the bursting of the bubble and the ensuing

[1] The Federal Open Market Committee is the monetary policy making body of the Fed, and which meets eight times a year or more if need be. During these meetings the members try to assess the economy and policy options, and the FOMC issues a policy statement following each regular meeting that summarizes the Committee's outlook and the policy decisions at that meeting.

collapse which completely dominated any effects attributed to these meetings or announcements of policy changes.



Source: www.federalreserve.org, Robust Methods LLC

By 2008, the Fed's conventional monetary policy had reached its limits in its ability to continue to inflate the financial bubble, and left the central bank completely out of any of its policy tools. Words like 'dovish' or 'hawkish' became empty, and could no longer have any effect, besides short-lived attempts at influencing the market.

Instead of taking responsibility and apologizing to the public, the Fed resorted to cheating, and labeled its work as an 'unconventional monetary policy' - a sanitized term to counterfeiting and debt-monetization, coupled with very doubtful promises of an 'exit strategy' at a later time in the future.

The 2008-2009 period on the chart hence marks the beginning of a new market regime, and in which the flood of money printing took over everything else. The debasement of the currency and the reflation of asset prices has been running full throttle since.

From a risk perspective, and looking back over the past 22 years, the table below shows the effect of the central bank's policy on the volatility of the S&P 500.

Using the FOMC meetings announcements as a proxy to the Fed's policy again, the divergence between the volatility of both cumulative data series is clearly too wide to ignore.

Risk Effect of FOMC Meetings

Index	Standard Deviation
S&P (including FOMC days)	103.76
S&P excluding FOMC days	40.04

The basic observation is that the meetings have increased the risk of the S&P 500 from an index level of 40 to 103, effectively multiplying the risk born by investors by a factor of 2 ½.

Further, and given that the 'S&P index ex. the FOMC meetings' is significantly lower than the unadjusted index, it's fairly clear that the policy decisions were always one-sided instead of balanced. They were consistently aimed at keeping interest rates suppressed to very low levels, while inflating the prices of financial assets to excessive and irrational levels.

With the S&P 500 being dominated first and foremost by the Fed's monetary policy, and as its returns became mainly determined by the FOMC meetings, it is no surprise that most equity investment strategies became blurred and lost a good deal of their granularity and definition.

Not only did the economic equation become less relevant, but the link between the stock market and its fundamental drivers got to the point of becoming completely reversed: Bad fundamental news inevitably led the market to conclude that the Fed will keep interest rates below market levels.

This newly found certainty in the market, and the predictability of the Fed's actions, created a new paradoxical pattern; a rising stock market against worsening fundamentals, instead of the opposite being the case.

That same argument translates to individual stocks, and where companies with risky and highly indebted balance sheets became the main ones to benefit from the negative interest rates, set by the FOMC, at the expense of healthier companies.

Firms with a conservative financial policy that did not hold debt or carried excess cash did not stand to benefit from the negative rates. Instead of earning an interest income on their cash balances and short-term instruments, they saw their cash positions bleed value over the years.

Firms with risky and levered balance sheets consistently benefited from the negative rates on the other hand. Instead of paying a premium to service their debt, they were rewarded by the Fed at the expense of the more prudent companies, and dollar holders by large.

The Fed's policy has hence directly forced a most unfair treatment among the various financial parties, and subsidized borrowing and risk taking at the expense of the more stable elements in the financial ecosystem.

All markets and sectors became distorted, and were left with little room, if at all, to discover their proper price levels, as result of the Fed's policy.

As of this writing, a Bloomberg news headline prints: “Goldman Sachs, Citigroup, Received Fed Minutes Early”.

Given the sensitivity and impact of the FOMC announcements we describe in this work, we leave it to the reader to guess whether this was an unusual accident or another serious moral hazard.

To summarize this article, the price of the S&P has been, over the past 22 years at least, the direct result of a twisted monetary policy, first, second, and third, instead of being a reflection of actual intrinsic value of its component stocks, or economic progress and profitability.

After the initial bursting of the housing bubble around mid-2007 and which was followed by the global financial implosion in 2008, the Fed’s conventional policy tools became totally useless and ineffective. At which point, the central bank decided to resort to the unthinkable measures of money printing, direct asset purchases, and debt-monetization.

The FOMC’s long standing policy of artificially low interest rates creates major inequities in the financial markets among the various players. It systematically has been rewarding the large borrowers, such as the banking system, the government, and the levered corporations, at the expense of the savers and prudent corporations which hold no or little debt.

Further, a policy of systematically setting rates below market levels is clearly aimed at accelerating credit creation and interest revenues to its member banks, at the public cost of enormous financial bubbles, and the inevitable devastating implosions which are surely to follow.

No longer being able to maintain this scheme using negative real interest rates, the Fed made the decision to debase the currency and allocate its private losses to the public.

With the charter of the Fed being aimed at economic growth, and price and financial stability, it is beyond interesting to note that it has delivered exactly the opposite of what it promised. Evidence shows that the Fed is both: The source of volatility, and the chief architect of cataclysmic boom and bust cycles.

Finally, the more recent and experimental promises made to the public to justify the money printing have failed to materialize after several years. If anything, the printed currency has only helped the Fed’s owners take colossal sums of free money from dollar holders, against a yet to be fully discovered public cost.

Added to the above, and most expensive of all, is the invaluable opportunity cost of perpetuating an unscientific, flawed, and immensely inequitable financial model.

Appendix

1. Table of FOMC meetings

1990/1991	1992/1993	1994/1995/1996	1997/98/99	2000/2001	2002/2003	2005/2006	2007/2008	2009/2010	2011/2012
2/6/1990	2/4/1992	2/3/1994	2/4/1997	2/1/2000	1/29/2002	2/1/2005	1/30/2007	1/16/2009	1/25/2011
2/7/1990	2/5/1992	2/4/1994	2/5/1997	2/2/2000	1/30/2002	2/2/2005	1/31/2007	1/27/2009	1/26/2011
3/27/1990	3/31/1992	3/22/1994	3/25/1997	3/21/2000	3/19/2002	3/22/2005	3/20/2007	1/28/2009	3/15/2011
4/11/1990	5/19/1992	5/17/1994	5/20/1997	5/16/2000	5/7/2002	5/3/2005	3/21/2007	2/7/2009	4/26/2011
5/15/1990	6/30/1992	6/5/1994	7/1/1997	6/27/2000	6/25/2002	6/29/2005	9/5/2007	3/17/2009	4/27/2011
7/2/1990	7/1/1992	6/6/1994	7/2/1997	6/28/2000	6/26/2002	6/30/2005	6/27/2007	3/18/2009	6/21/2011
7/3/1990	8/18/1992	8/16/1994	8/19/1997	8/22/2000	8/13/2002	8/9/2005	6/28/2007	4/28/2009	6/22/2011
8/21/1990	10/6/1992	9/27/1994	9/30/1997	10/3/2000	9/24/2002	9/20/2005	8/7/2007	4/29/2009	8/1/2011
9/7/1990	11/17/1992	11/15/1994	11/12/1997	11/15/2000	11/6/2002	11/1/2005	8/10/2007	6/3/2009	8/9/2011
9/17/1990	12/22/1992	12/20/1994	12/16/1997	12/19/2000	12/10/2002	12/13/2005	8/16/2007	6/23/2009	9/20/2011
10/2/1990	2/2/1993	1/31/1995	2/3/1998	1/30/2001	1/28/2003	1/31/2006	9/18/2007	6/24/2009	9/21/2011
11/13/1990	2/3/1993	2/1/1995	2/4/1998	1/31/2001	1/29/2003	3/27/2006	10/30/2007	8/11/2009	11/1/2011
12/18/1990	3/23/1993	3/28/1995	3/31/1998	3/20/2001	3/18/2003	3/28/2006	10/31/2007	8/12/2009	11/2/2011
2/5/1991	5/18/1993	5/23/1995	5/19/1998	5/15/2001	5/6/2003	5/10/2006	12/6/2007	9/22/2009	11/28/2011
2/6/1991	6/6/1993	7/5/1995	6/30/1998	6/26/2001	6/24/2003	6/28/2006	12/11/2007	9/23/2009	12/13/2011
3/26/1991	6/7/1993	7/6/1995	7/1/1998	6/27/2001	6/25/2003	6/29/2006	1/9/2008	11/3/2009	1/24/2012
5/14/1991	8/17/1993	8/22/1995	8/18/1998	8/21/2001	8/12/2003	8/8/2006	1/21/2008	11/4/2009	1/25/2012
7/3/1991	9/21/1993	9/26/1995	9/29/1998	10/2/2001	9/15/2003	9/20/2006	1/29/2008	12/15/2009	3/13/2012
7/2/1991	11/16/1993	11/15/1995	11/17/1998	11/6/2001	9/16/2003	10/24/2006	1/30/2008	12/16/2009	4/24/2012
10/1/1991	12/21/1993	12/19/1995	12/22/1998	12/11/2001	10/28/2003	10/25/2006	3/10/2008	1/26/2010	4/25/2012
11/5/1991		1/30/1996	2/2/1999		12/9/2003	12/12/2006	3/18/2008	1/27/2010	6/19/2012
12/17/1991		1/31/1996	2/3/1999		1/27/2004		4/29/2008	3/16/2010	6/20/2012
		3/26/1996	3/30/1999		1/28/2004		4/30/2008	4/27/2010	7/31/2012
		5/21/1996	5/18/1999		3/16/2004		6/24/2008	4/28/2010	8/1/2012
		7/2/1996	6/29/1999		5/4/2004		6/25/2008	5/9/2010	9/12/2012
		7/3/1996	6/30/1999		6/29/2004		7/24/2008	6/22/2010	9/13/2012
		8/20/1996	8/24/1999		6/30/2004		8/5/2008	6/23/2010	
		9/24/1996	10/5/1999		8/10/2004		9/16/2008	8/10/2010	
		11/13/1996	11/16/1999		9/21/2004		9/29/2008	9/21/2010	
		12/17/1996	12/21/1999		11/10/2004		10/7/2008	10/15/2010	
					12/14/2004		10/28/2008	11/2/2010	
							10/29/2008	11/3/2010	
							12/15/2008	12/14/2010	
							12/16/2008		

Source: www.federalreserve.gov Official Website of the Federal Reserve